CENTER FOR CAPITAL MARKETS COMPETITIVENESS

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Ms. Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles (File No. S7-24-15)

Dear Secretary Countryman:

The U.S. Chamber of Commerce's ("the Chamber") Center for Capital Markets Competitiveness ("CCMC") welcomes this opportunity to comment on both the U.S. Securities and Exchange Commission's ("SEC" or "Commission") re-proposal of rule 18f-4 (the "Re-Proposed Rule"), which modifies the regulatory regime governing the use of derivatives by registered investment companies ("RICs") and business development companies ("BDCs" and, together with RICs, "funds") and the Commission's new proposed rules 15*l*-2 and 211(h)-1 (the "sales practice proposal"), which would create new sales practice rules for transactions involving leveraged or inverse investment vehicles.

As we stated in our letter in response to the Commission's original 18f-4 proposal in 2015 (the "2015 Proposal"),[1] we generally support the SEC's goal of updating the derivatives regulatory regime applicable to funds under Section 18 of the Investment

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[1] See Letter from Tom Quaadman, Executive Vice President, U.S. Chamber of Commerce, March 28, 2016, *available at* https://www.sec.gov/comments/s7-24-15/s72415-148.pdf

Company Act of 1940 (the "1940 Act"). Given the increased importance of the use of derivatives in managing funds, we recognize the benefit from modernizing the regulatory framework on funds' use of derivatives, and believe it is appropriate for the Commission to address these issues as the sole agency with the requisite ability to balance the tripartite mission of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation. However, the Chamber had serious concerns with the 2015 Proposal, which we believe would have created unworkable limits on the use of derivatives and financial commitment transactions for many different types of funds.

The Re-Proposed Rule includes many improvements from the 2015 Proposal, particularly in its new approach to a Value at Risk (VaR) limit on fund leverage risk and risk management requirements. However, there remain additional areas of improvement and clarification the SEC should effectively address before finalizing the rules.

Background and General Comments

RICs, BDCs, and asset management companies play a critical role in the capital markets and U.S. retirement system and are some of the most highly regulated entities in the financial industry. We believe the SEC should consider the existing regulatory regime that applies to these vehicles and carefully deliberate the impact that new rules and limitations will have on funds and their shareholders.

According to the Investment Company Institute, RICs managed $21.4 trillion in assets at year-end 2018 on behalf of more than 101.6 million investors.[2] At the end of 2018, publicly traded BDCs collectively held approximately $70 billion in total assets.[3] BDCs, once a nascent industry, have grown considerably as sources of capital for middle market businesses and now have roughly $100 billion in assets under management.

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[2] Investment Company Institute, 2019 Investment Company Fact Book, *available at* https://www.ici.org/pdf/2019_factbook.pdf

[3] Morningstar Credit Ratings, LLC, *"Business Development Companies Are Revving Up for Growth,"* April 3, 2019, *available at* https://ratingagency.morningstar.com/PublicDocDisplay.aspx?i=XEsJSPQMd18%3D&m=i0Pyc%2Bx7qZZ4%2BsXnymazBA%3D%3D&s=LviRtUKXqs8kml5dHt7FTeE2SZmY0Fvqd4iX49Mk%2F9UapyiFTEO6TA%3D%3D

Our economy benefits from the wide variety of funds available to investors today. Mutual funds invest in hundreds of securities and provide investors with the benefit of broad diversification while reducing an individual's aggregate risk exposure. The fund industry's diversity means that funds will also employ different trading strategies to reach their investment objectives. This may include the use of derivatives to reduce potential risk or deliver investment performance by gaining additional exposure.

We should also recognize the important benefits that derivatives provide to funds, their investors, and the broader capital markets. Funds can use derivatives to hedge their own risk in a number of different ways, ranging from liquidity risk to currency risk, which helps preserve the economic return sought by investors. Importantly, derivatives can be used to gain or lower exposure quickly and cheaply where it may be slow or costly to do so by purchasing or selling individual securities. This added liquidity inures to the benefit of the market and the U.S. economy by permitting continued investment by funds and access to capital for companies through the public markets.

Comments on the Re-Proposal of Rule 18f-4

Portfolio Limitation

Under the Re-Proposed Rule, the SEC would require funds utilizing derivatives transactions to utilize a VaR limit on fund leverage risk. A fund would be required to calculate the VaR of the fund's portfolio and compare it to the VaR of a designated reference index (an unleveraged index that reflects the markets or asset classes in which the fund invests). A fund's VaR cannot exceed 150 percent of the reference index or 15 percent of the value of the fund's net assets if no index is found.

We applaud the SEC for moving away from the approach taken in the 2015 Proposal, which would have required compliance with one of two alternatives: (1) an "exposure-based limit," limiting its aggregate exposure to 150 percent of the fund's net assets or (2) a "risk-based limit," permitting a fund to obtain exposure up to 300 percent of a fund's net assets if the fund also satisfies a value-at-risk analysis.

We understand that many firms already utilize VaR for risk management purposes, and the Re-Proposed Rule would establish a reasonable regulatory framework for such practices. While we recognize the improvement in the approach to the limit on fund leverage risk, we are concerned about the limit values chosen by the SEC. We

believe the relative limit of 150 percent of the VaR of the fund's designated reference index and absolute limit of 15 percent of the fund's net assets are insufficient limits given usage by funds. We recommend that the SEC instead consider aligning its portfolio limitations with those adopted by the European Union in its Undertakings for Collective Investment in Transferable Securities (UCITS), whereby funds that utilize derivatives are subject to a relative limit of 200 percent of the VaR of the fund's designated reference index and absolute limit of 20 percent of the fund's net assets.

We also encourage the SEC to consider developing greater clarity around a fund's ability to select the use of the absolute VaR test when appropriate. The SEC should provide additional guidance and clear examples of situations in which the derivatives risk manager will not be able to identify an appropriate index.

Board Requirements

In our March 28, 2016 comment letter, CCMC supported the adoption of a formal derivatives risk management program for funds. However, we expressed concern at the lack of flexibility granted to funds to either appoint a designated risk manager or opt for a committee of qualified individuals to assume this role. The Re-Proposed Rule calls for the derivatives risk manager to be held by a fund adviser's officer or officers. We support the provisions allowing funds the flexibility to choose between a single risk manager or multiple officers. It is appropriate to allow "funds with differing sizes, organizational structures, or investment strategies to more effectively tailor the programs to their operations."[4] We further encourage the SEC to align its definition of derivatives risk manager with that of a liquidity risk manager in Rule 22e-4, which allows an officer, officers, or a fund's investment adviser to serve the role of liquidity risk manager. Allowing a fund's investment adviser to also serve in the capacity of derivatives risk manager would provide a fund's board with greater flexibility in establishing a derivatives risk management program with the appropriate level of experience to administer the program.

In line with our 2016 comment letter, we continue to strongly advise the SEC to protect a derivatives risk manager (or multiple officers serving in that role) from legal liability. As we explained in our 2016 comment letter, given the inherent potential for incorrect but well-intentioned decisions about how to reduce a portfolio's risk exposure, it is important to clarify that a derivatives risk manager acting in good faith would be shielded from liability for the normal performance of derivatives transactions.

[4] Release No. 34-87607; File No. S7-24-15, page 48.

In addition, the Re-Proposed Rule still does not clarify whether a fund may terminate a derivatives risk management program if it falls below the established threshold or ceases using derivatives. This section of the Re-Proposed Rule could also benefit from clearer guidance regarding when a fund would have to implement a derivatives risk management program once it crosses the 10 percent threshold. For example, if a fund for any reason happened to cross above 10 percent for a matter of days or weeks then fell back below the threshold, what obligations might it incur and how long would it have to implement a derivatives risk management program? Also, we ask the SEC to clarify whether early-stage funds need to implement a derivatives risk management program if they will quickly fall below the 10 percent threshold (e.g., situations in derivatives are used in the "ramp-up" of a fund, but the use of derivatives "rolls off" as a fund is capitalized).

Finally, the Re-Proposed Rule establishes two primary guidelines for board oversight of the risk management program: (1) board approval of the derivatives risk manager and (2) regular written reporting by the derivatives risk manager to the board on the reference index chosen and the effectiveness of the risk management program. Further, the Re-Proposed Rule states the SEC's view that "it should be the responsibility of the derivatives risk manager to choose the appropriate VaR model for the fund's portfolio"[5] and that the "board's role is to oversee the activity of the risk manager."[6] In line with these statements and CCMC's 2016 comment letter, we encourage the SEC to establish and maintain a clear delimitation of responsibilities between the risk manager and the board such that the board's role remain one of general oversight per the SEC's interpretation in Rule 38a-1 of the 1940 Act.[7]

Business Development Companies

CCMC's 2016 comment letter also expressed concern about the application of the same portfolio limitations to BDCs as it would to other funds. The Re-Proposed Rule does the same. We continue to believe such a proposal is inappropriate because it fails to recognize the meaningful operational differences between BDCs and other funds, and contradicts specific Congressional intent to provide greater leverage capacity to BDCs for the express purpose of increasing the flow of capital to small and mid-size U.S. businesses. Consequently, we believe the Re-Proposed Rule should impose no new or different restriction on the borrowing or lending activities permitted of BDCs

[5] Release No. 34-87607; File No. S7-24-15, page 119.
[6] Release No. 34-87607; File No. S7-24-15, page 85.
[7] https://www.sec.gov/rules/proposed/ic-25925.htm#chief

in the 1940 Act, and any exposure-based limitation applicable to BDCs under the Re-Proposed Rule should reflect the greater leverage capacity extended to BDCs by Congress.

Comments on the Proposal of Sales Practice Rules 15l-2 and 211(h)-1

The SEC did not include a proposal on sales practice requirements for leveraged and inverse exchange-traded funds (ETFs) in its 2015 Proposal. According to the new sales practice proposal, broker-dealers and investment advisors would only be able to transact in leveraged or inverse funds if they have a "reasonable basis to believe that the customer or client is capable of evaluating the risk associated with"[8] leveraged or inverse products. Such approval for each investor would be made based on the evaluation of a uniform set of due diligence.

CCMC is mindful that the SEC's Regulation Best Interest ("Reg BI") will be fully implemented on June 30, 2020. In order to strengthen investor protections, Reg BI requires broker-dealers to put the financial interests of their customers first when making investment recommendations. At this time, we question the need for a heightened sales practice beyond Reg BI that is focused on only a handful of investment products, when Reg BI has not been fully implemented. As such, we call on the SEC to delay consideration of another sales practice rule until such time that Reg BI can be fully assessed.

Conclusion

We commend the SEC for making substantial improvement to its proposal on funds' use of derivatives. We encourage the SEC to incorporate several necessary modifications and clarifications to its proposal, as discussed above.

We thank you for your consideration of these comments and would be happy to discuss these issues further.

[8] Release No. 34-87607; File No. S7-24-15, page 34.

Sincerely,

Kristen Malinconico

cc: The Honorable Jay Clayton
The Honorable Hester M. Peirce
The Honorable Elad L. Roisman
The Honorable Allison Herren Lee